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ABSTRACT

Designed for first-time borrowers, this pamphlet describes the basics of credit as a part of personal financial planning. Following a self-quiz (with answers) that tests the reader's knowledge of credit, the pamphlet provides guidelines for responsible credit use and outlines steps to take if debt problems occur. Topics covered include the following: credit for the first-time borrower, how much credit can one afford, shopping for a loan, shopping for a credit card, credit bureaus and credit reports, monitoring credit card use, warning signs of debt problems, and do's and don'ts of handling a financial crisis. (KC)

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How to Be... Credit Smart.

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"Straight Talk" SERIES

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CREDIT-ABILITY SCORECARD

Test your credit I.Q. For each question, circle the letter that best describes your credit habits.

1. **I pay my bills when they are due.**
   (A) Always (B) Almost Always (C) Sometimes
2. **After paying my regular bills each month, I have money left from my income.**
   (A) Yes (B) Sometimes (C) Never
3. **I know how much I owe on my credit cards each month before I receive my bills.**
   (A) Yes (B) Sometimes (C) No
4. **When I get behind in my payments, I ignore the past due notices.**
   (A) Never or Not Applicable (B) Sometimes
   (C) Always
5. **When I need more money for my regular living expenses, I take out a loan or use my line of credit on my credit card or checking account.**
   (A) Never (B) Sometimes (C) Often
6. **If I want to see a copy of my credit report, I would contact . . .**
   (A) A credit reporting agency (B) My lenders
   (C) My lawyer
7. **My credit record shows that I am current on all my loans and charge accounts.**
   (A) Yes (B) Don't know (C) No
8. **I pay more than the minimum balance due on my credit card accounts.**
   (A) Always (B) Sometimes (C) Never
9. **To pay off my current credit and charge card accounts, it would take me . . .**
   (A) 4 months or less (B) 5 to 8 months
   (C) Over 8 months
10. **My consumer loans (including auto loans, but not mortgage payment) and credit card bills each month average more than 20% of my take home pay.**
    (A) No (B) Sometimes (C) Always
11. **If I had serious credit problems, I would contact my creditors to explain the problem.**
    (A) Yes (B) Probably (C) No
12. **If I default (don't repay) on a loan, that fact can stay on my credit report for . . .**
    (A) 7 years (B) 3 years (C) 1 year

Assign a score of 3 for each "A" answer, 2 for each "B" answer; and 1 for each "C" response. Total the score.

If you scored:

31-36 You have an excellent knowledge of credit and its responsible use.

24-30 You should take steps toward a better understanding of your personal finances and of the credit process.

18-23 You probably need to take a serious look at your personal finances; consider controlling your spending and keeping on a tight budget.

12-17 You may be heading for serious trouble; consider seeking help, such as non-profit consumer credit counseling services.

Credit in Your Life

Every year financial institutions lend billions of dollars to consumers in the United States. Most people who borrow money have established credit histories. However, many other people -- especially young people -- are borrowing for the first time and have to learn how to use credit.

If handled responsibly, credit can be a useful tool to help achieve financial goals and enhance the quality of a person's life. On the other hand, if credit is not used wisely or is abused, problems will follow. This brochure highlights important information about how to obtain, use, and benefit from credit. It is designed to help first-time borrowers understand the credit process; to provide guidelines for responsible credit use; and to outline steps to take if debt problems occur.

Credit for the First-Time Borrower

Today, credit is almost a necessity. Even if a person prefers to use cash, paying by check, renting a car, or guaranteeing a hotel reservation is difficult without a credit card.

How does a person obtain credit? When a person applies for a loan or credit card, the financial institution makes a judgment based on what is often referred to as the "3 Cs": character (how a person has handled past

debt obligations), capacity (how much debt the person can comfortably handle), and collateral (the person's assets).

A person without a credit history, who has never had credit, may have problems getting that first loan. But, there are options available:

- Ask a close friend or relative to co-sign for a loan. In doing this, the co-signer is guaranteeing that payments will be made on time and in full. If the credit user does not repay the loan, the co-signer will be legally responsible for doing so.
- Apply for a local retailer's charge card. This can be the first step toward applying for a major credit card, once a person has shown an excellent payment record.
- Open a checking and savings account at a local financial institution. If the customer handles the checking account responsibly and proves to be a valued account holder, the institution may grant the person a small loan or offer a credit card.
- People interested in purchasing a new car can apply for an auto loan. Automobile finance companies offer special programs tailored to first-time borrowers.
- Buy the appliances or home furnishings you need using the credit plan of a local retailer.
- Take advantage of credit cards that are often offered to college students or recent graduates.
- Investigate "affinity group" credit cards which are often made available to members of a particular union, professional or interest group.

Once credit is granted, first-time borrowers should remember that this first account is the beginning of his or her credit record, which will form the basis for future credit.

How Much Credit Can You Afford?

Consumer finance experts all agree that before making decisions about adding more debt, always make sure enough money is allocated to essentials -- including a regular savings account. Other good rules of thumb are: borrow only for things that will make a significant contribution to your family and lifestyle; and borrow only if you're spending less each month than you take home, and the additional debt load will not cut into the amount you've committed to savings.

The following steps will help you determine the amount of credit you can afford:

- Start with your monthly take-home pay-- the amount you have left after taxes and other deductions.
- From take-home pay, subtract the amount needed for necessities and fixed expenses. These include mortgage or rent payment, utilities, food, transportation, child care, etc. Don't forget other regular payments such as insurance and taxes that are paid on a quarterly, semi-annual, or annual basis.
- Subtract average monthly bills for existing loans or credit cards.
- Subtract other high priority expenses, such as savings, medical care, clothing, and recreation.
- The balance is the amount you can safely apply to debt repayment. Avoid thinking you can spend all of this amount, since emergencies do occur, and you may not wish to use your regular savings account to cover small, unexpected expenses.

Shopping for a Loan

If you need a large loan for a major purchase, such as a car or home, it pays to shop for the best value.

First, establish the amount you need to borrow. Then, check your financial situation -- your income and expenses -- to figure out what you can afford for the monthly payment without putting a strain on your finances.

You might begin to shop for credit with your current lending institution or ones recommended by family or friends. When visiting each institution, be sure to note the different rates and terms available.

Important attention should be paid to the annual percentage rate (APR--the rate charged on an annual basis) and the finance charge (the dollar cost of credit) on the loan amount you're contemplating. If you want to spread out your loan payments over a specified period of time, for example, three or five years, have the lender calculate what the monthly payments would be.

For lending institutions offering variable rate loans, ask the lender what the payments would be if the rate increased to the maximum. Other terms worth investigating include whether there are any penalties for repaying the loan early, and the expected turn-around time on your loan application.

Make sure that other terms of the loan contract are acceptable to you. Review the loan documents carefully and ask questions about any items you don't understand *before* you sign.

Shopping for a Credit Card

Just like other loan rates and terms, credit card rates and features vary. Determining which card is right for you depends on how you plan to use your credit card. It's helpful to classify yourself as one of these three types of credit card holders.

The Identification User. This credit card holder generally uses the card for identification in cashing checks, making hotel reservations and renting cars. Since this user doesn't carry over payments, the annual percentage rate (APR) charged is usually not the most important feature in selecting a card. More important would be the universal acceptance of the card and the annual fee charged. Annual fees on bank cards generally range from a low of $12 up to $25, with a few having no annual fee.

The "Non-Revolver." This person pays off the balance in full when due. For this user, the annual percentage rate isn't the most important characteristic. Instead, greater attention should be given to the allotted "grace" period--usually from 21 to 30 days--between the time a bill is sent out and the time interest is charged on the balance. Be sure to note other fees charged, such as transaction fees, late charges, or over-limit charges. For many non-revolvers, the amount of the credit limit is also a factor, especially if the card is used for business or vacation travel.

The Revolving Credit User. For the credit card user who doesn't pay off the monthly balance and carries a balance over from month to month, the annual percentage rate (APR) is usually the most important factor. Bank cards' APR can vary from 12 percent to 22 percent, with an average of about 19 percent. Another important consideration is how interest is calculated; for example, whether payments made during the month are deducted when figuring the average daily balance. Cards also vary by the minimum monthly payment required, often calculated as a percentage of the outstanding balance.

In addition to the features listed above, other credit card features are available. These include rebates or discounts on purchases made with the card, warranties on credit card purchases, the ability to obtain cash on a 24-hour basis by using the card at an ATM, travel insurance, travel and reservation services, shoppers' guides, and extra cards for family members.

While not everyone fits neatly into one of these three categories of credit card holders, a mix of the factors listed above may need to be considered when choosing the best credit card for you.

Credit Bureaus and Your Credit Report

What do credit bureaus do . . . and what don't they do? What kind of information is kept about you? How can you find out what's in your credit report? What steps should be taken to correct information?

Credit Bureaus. A credit bureau is essentially a clearing house of personal and financial information about you and how you have handled credit. Individual lenders provide much of the information about credit accounts to the credit bureaus, and in return rely on them for data about how loan applicants handle their debts.

Your Credit File and Its Use. Your credit file will usually contain: personal data, such as your current and former address, marital status, age, social security number; your employment history; any information on you from public records, such as judgments or bankruptcy; your credit accounts, including the date each was opened, the amount and balance, the status of the account, your pattern of payment, and the date of the last activity on the account; the number of inquiries about your credit record, as well as the date and the name of the company making the inquiry.

Information about your use of credit is routinely updated and submitted to credit bureaus. Some information, such as defaulting on a loan and declaring bankruptcy, may stay on your credit record for up to 7

and 10 years, respectively.

The decision to grant credit is made not by the credit bureau, but by the lender, who uses the credit report and other information to determine if you meet its standards of "creditworthiness."

If you are denied credit because of information in a credit bureau report, under the Fair Credit Reporting Act, that fact and the name of the credit reporting agency that provided the report must be disclosed to you. Then, within 30 days, you can request a free copy of your report from that credit bureau to find out what information caused your application to be rejected.

Even if you're never turned down for credit, it's useful to review your credit files periodically. Obtaining a copy of your report will cost between $8 to $15. To do so, check in the yellow pages under "credit bureaus" or "credit reporting agencies," and write requesting a copy of your report.

Lenders who subscribe to the credit bureaus and other authorized persons may inquire about your credit record. However, Federal laws impose criminal penalties for illegally obtaining individuals' credit information.

Disputing Information. Most credit bureaus provide a short explanation of how to read a credit report and what steps to take if you dispute information in your file.

If you find incorrect information in your credit report, you have the right to dispute it. This should be done in writing, both to the credit bureau asking them to verify the information and to the creditor that supplied the information to the credit bureau.

Even when the creditor and you don't agree, you can have your version of the facts included as part of your credit record.

On occasion, errors are found, and corrections are made to reports that do contain inaccurate data. It's in the best interest of credit bureaus to have accurate information in their files. That's the service they sell to their clients. It's also in your interest to take steps to be sure your credit report is up-to-date and presents an accurate picture of how you have handled credit.

Monitoring Credit Card Use

Many people may find themselves with cred problems because they don't always keep track of pu chases made with credit cards, and are shocked at th amounts they owe when the bills arrive. Here's simple ongoing method for keeping track of credit car charges:

- ❑ At the beginning of each month, set the tot amount you can afford for credit card charges. Thi total should be the amount you can responsibly charg on all your credit card accounts during that month.
- ❑ Some people use the amount they can pay i full when the bills are due. But if you carry over you balance, a useful rule of thumb is to set your total a what you can comfortably repay in three months o less. If your current balances will require six months o more to repay, you should consider curtailing you credit card use.
- ❑ Keep track of your credit spending in the sam way you keep a running balance of your checkin account: from the monthly charge limit you set, sub tract each amount you charge. It's useful to keep a sma note pad with your checkbook to record your cred purchases immediately and tally your balance.
- ❑ If you draw that "balance" down to zero, yo should stop using your credit cards that month.

Warning Signs of Debt Problems

Most people who use credit handle their debt responsibly. For some, however, debt problems ma occur for a variety of reasons. However, there ar usually warning signs that signal action needs to b taken now to avoid more serious problems later:

- ❑ Not knowing how much you owe until the bills arrive.
- ❑ Making only minimum payments on credit cards and other revolving loan accounts.
- ❑ Juggling bill payments each month.
- ❑ Using a line of credit on a credit card or checking account for regular expenses like food or rent.

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- ❑ Working overtime just to keep up with your spending.
- ❑ Going over your credit limit on credit cards.
- ❑ Having little or nothing in savings to handle unexpected expenses.
- ❑ Getting calls from creditors requesting payment.
- ❑ Being denied credit because of a negative credit bureau report.
- ❑ Getting a credit card revoked by the issuer.

If several of these warning signs apply to you, you need to cut back on your use of credit, put yourself on a budget, and consider getting some outside help.

Facing a Financial Crisis

Many factors can prevent families from meeting credit obligations. A sudden medical emergency or unexpected job layoff can seriously disrupt the most stable of budgets. How someone responds to debt problems during trying times can have a direct impact on his or her ability to obtain credit in the future. Ignoring debt obligations will only serve to compound the problem and hurt a person's chances of getting future credit. Here's a list of "do's" and "don'ts" in dealing with debt problems.

DO consider credit a serious obligation and always examine your budget carefully before taking on more debt. Remember, your total borrowing, not counting your housing allowance, should not exceed 20 percent of take-home pay.

DO sit down with a pencil and paper and rework your budget at the first sign of problems. Try to find areas where you can cut back, so you can devote more of your income to paying bills.

DO contact your creditors to let them know you're having problems, if you can't make payments on time.

DO make arrangements to extend your repayment period or, if possible, lower your minimum payments, if the monthly amounts are larger than you can meet.

DO try to work with your creditors first if problems occur. In many cases, they'll offer you other options.

DO contact your local, non-profit Consumer Credit Counseling Service if your problems are severe and you're unable to handle the situation yourself.

DON'T take on more debt when you're trying to get back on financial track.

DON'T hide from your creditors if your financial problems are serious.

DON'T be unrealistic in your promises to your creditors.

DON'T consider bankruptcy unless you've exhausted all other alternatives. Bankruptcy can stay on a person's credit record for up to ten years, and it can seriously impair your ability to obtain credit in the future.

Contact the National Foundation for Consumer Credit (301) 589-5600 for more information about non-profit Consumer Credit Counseling Services.

Other "Straight Talk" Brochures

"What You Should Know Before Declaring Bankruptcy," the first brochure in the "Straight Talk" series published by AFSA Consumer Credit Education Foundation, provides consumers with information on personal bankruptcy.

The bankruptcy brochure explains the difference between a Chapter 7 and 13 filing, and suggests alternatives to filing for bankruptcy. To obtain your free copy, send a self-addressed stamped business size envelope to: AFSA Consumer Credit Education Foundation, 919 18th St. N.W., Dept. DB, Washington, D.C. 20006.

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